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RESEARCH ARTICLE

The Study on the Impacts of Capital Structure on Corporate Financial Performance in Food Manufacturing and Hotel Industries: Evidence from SMEs in U.K.

Dianjie Liang[1], Rongjia Su[2]*

[1]*Nottingham Business School, Nottingham Trent University, United Kingdom.*

[2] *College of International Studies, Sichuan University, China.*

***Corresponding Author: Rongjia Su**

Abstract: This study aims to investigate the influence of capital structure on financial performance of small and medium sizes enterprises (SMEs) in food manufacturing and hotel industries in U.K. Data are collected from Financial Analysis Made Easy (FAME) database and least square regression analysis is applied to examine the impacts. Research results show that capital structure has a negative effect on financial performance in food manufacturing industry in U.K. However, mixed results are found in hotel industry. Capital structures have a negative impact on return on assets (ROA), while Capital structure affects return on equity (ROE) positively. Therefore, financial managers should not blindly employ debt without regard to industrial characteristics.

Keywords: *Capital structure, Corporate financial performance, Hotel industry, Food manufacturing.*

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Introduction

Capital structure is a major area of interest in the field of corporate finance. Capital structure, as suggested by Baker and Martin [1], refers to the capital raised through debt, equity and hybrid securities by a firm, indicating the cost of corporate capital. It represents the combination of equity and debt and cost of capital. In fact, Gleason, Mathur [2] hold the view that a firm could improve performance by an optimal capital structure when other factors are equal, since an optimal capital structure could lead to maximum net return to the firm through minimum cost of capital.

However, given the different natures of industries, capital structure might perform different role in profitability. However, given the different natures of industries, capital structure might perform different role in profitability. Hotel industry and food manufacturing are chosen because the different industry characteristic would lead to different asset structure and capital preference. For example, due to the short shelf life in food manufacturing industry, the cash conversion cycle may affect the financial performance and liquidity [3], while this is not the case in hotel industry, hotel location and tourist destination may impact the financial performance [4].

Moreover, most of the empirical studies on capital structure use data from large firms, while a limited number of studies concentrate on the role of capital structure in SMEs.

Nevertheless, Pettit and Singer [5] point out that asymmetric information and agency problem are more complex in SMEs than that

in large firms. In addition, SMEs perform a pivotal role in economic growth and development [6, 7], it is important to investigate factors affecting the profitability of SMEs. Hence, this study attempts to assess the link between capital structure and financial performance of SMEs in hotel and food manufacturing industries industry in UK. The remainder of our paper is structured as follows.

First, we present a review of the theoretical background on capital structure and financial performance and develop hypotheses. The next part describes the research methodology, and presents the result of our analyses. The final part shows conclusions, discussions, and limitations and provides direction for future research.

Literature Review and Hypotheses

Theoretical Background

A growing number of literatures have examined the relationship between capital structure and financial performance. Modigliani and Miller [8]. Propose that capital structure is not pertinent to the value of a firm under specific assumptions, including tax free, perfect capital market, no financial distress cost and so on.

This model, known as MM no-tax model, suggests that managers may not improve corporate performance by adjusting capital structure in perfect capital market. Although these stringent assumptions are deemed as unreasonable [9], an innovative model was established by Modigliani and Miller to examine the role of capital structure.

Subsequently, tax was introduced into original model by Modigliani and Miller [10], demonstrating that firm performance could be enhanced by financing through debt rather than equity.

This is because tax-deductible interest payment enables firms to pay less tax, which could decrease the cost of debt and create more value. Consistent to the theory, the more debt is employed by firms, the more tax shield exists. Therefore, capital structure with 100% debt could maximize tax shield and the value of firm. Similarly, Myers [11] and Jensen [12] confirm high levels of debt could exert positive effect on firm performance.

A further model is given by Baxter [13], who takes bankruptcy cost into account and proposes Trade-off theory, indicating that a company may optimize capital structure to maximize corporate value. From another perspective, debt could undermine firm performance when the bankruptcy cost exceeds the tax benefits.

Nevertheless, Miller [14] points out that the bankruptcy cost is not sufficient to offset the tax shield, a firm could not explore no an optimal capital structure. Furthermore, the author states that the tax shield from corporate taxes would be offset exactly by personal taxes; therefore, tax would not exert impact on corporate value.

This view further supports the capital structure irrelevance theory [8]. Contrary to previously published studies, Pecking Order theory, furthered by Myers and Majluf [15], illustrates that a less profitable enterprise employs a higher level debt than profitable ones, suggesting an averse link between debt and profitability.

This theory claims that, owing to asymmetric information and adverse selection problems, firms prefer internally generated resources (i.e. retained earnings) to financing new investment rather than debt and equity.

Since issuing equity is considered as a bad signal, leading investors to believe that the shares are overvalued, firm's shares will subsequently decline. In order to avoid the negative influence of equity issue, firms perceive debt as second choice of financing; hence, equity becomes the last resort.

The Pecking Order theory demonstrates that highly profitable companies have a low

financial leverage, while less profitable ones with inadequate internal funds resort to debt for new investment [16].

Effects of Capital Structure on Financial Performance

A variety of empirical studies pertaining to the capital structure theory show mixed and conflicting results. First of all, Salim and Yadav [17] utilize 237 Malaysian listed firms as sample to assess the link between capital structure and firm performance.

Their study confirms performance indicators, which are ROE, ROA, EPS and Tobin's Q, have a reverse relationship with short term debt (STD), long term debt (LTD), total debt (TD) Also, Mwangi, Makau [18] investigate the influence of financial leverage on non-financial listed firms; They find that financial leverage has a significantly adverse impact on return on asset (ROA) and return on equity (ROE) representing financial performance, which supports the Pecking Order theory.

They suggest that poor performance of non-financial firms associates to a high level of long-term debt. The result is proved by other studies [2, 19, 21]. In contrast, a positive relationship is revealed by Nirajini and Priya [22]. They discover that long-term debt, debt asset ratio and debt-equity ratio have a positive effect on gross profit margin, return on capital employed, net profit margin (NPM), ROA and ROE.

The finding is in consonance with the study conducted by Gill, Biger [23], which demonstrates that capital structure relates positively to financial performance measured by earnings before interest and tax and ROE.

However, some studies show that results are neither consistent with the Trade-off theory nor the Pecking Order theory, indicating that capital structure is irrelevant to financial performance [24, 26]. Phillips and Sipahioglu [26]. Confirm there is not significant correlation between the level of debt and profitability with 43 hotel firms. In this study, debt to assets and gearing ratio (GR) are indicators for capital structure, profitability is measured by ROA and ROE. El-Sayed Ebaid [24].

Analyzes data from non-financial Egyptian listed firms. They find that capital structure does not have significant link with ROE, ROA and GPM. In the same vein, Enekwe, Agu [25] discover that financial leverage does not exert a significant influence on the profitability of Nigeria pharmaceutical companies.

In fact, only 16.4% of the variations on the financial performance, represented by ROA, result from financial leverage, including interest coverage ratio, debt ratio and debt-equity ratio. These studies based on pecking order theory propose hypotheses as follows to be tested:

H1

Gearing ratio has a significantly negative impact on ROE in hotel industry.

H2

Gearing ratio has a significantly negative impact on ROA in hotel industry.

H3

Gearing ratio has a significantly negative impact on ROE in food manufacturing.

H4

Gearing ratio has a significantly negative impact on ROA in food manufacturing.

Given the aforementioned arguments, this research examines effects of gearing ratio on financial performance in SMEs in hotel and food manufacturing industries in UK (see Fig. 1)

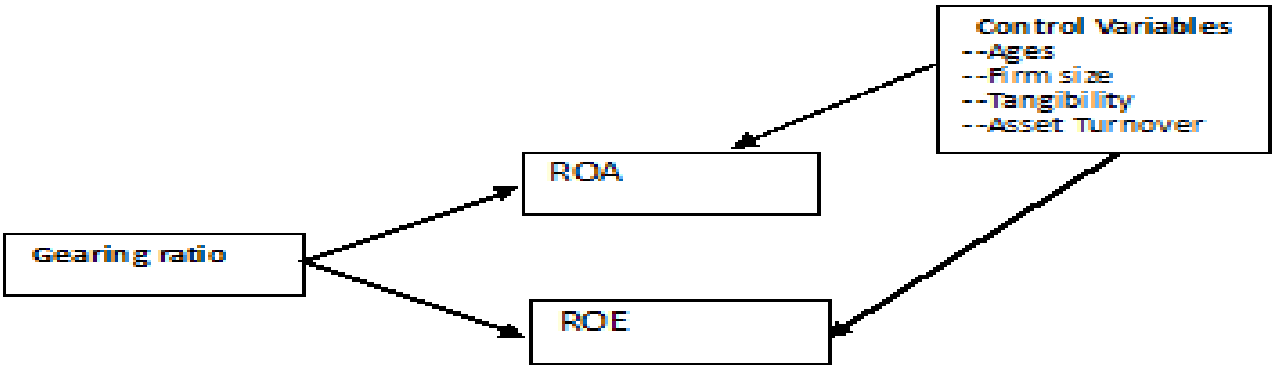

Fig.1. Theoretical model

Methodology

Data

Quantitative methods is suitable for the study regarding the relationship between various variables [27], because quantitative data could be processed to reflect the connection and tendency by quantitative analysis techniques [28]. In addition, statistic software offer an effective way to analyze data [29]. Hence, quantitative approach is applied in this study. Both EVIEWS 9.0 and EXCEL are used for data processing and calculations. This study selected SMEs respectively from hotel and food manufacturing industries, analyzing secondary data collected from FAME database.

FAME is a database covering over 11 million companies in the UK and Ireland, providing financial data, legal entity details, M&A activities, corporate structures and ownership(seehttps://www.bvdinfo.com/engb/ourproducts/data/national/fame#secondaryMenuAnchor1). Fame is the ideal tool for general financial research, this is because FAME provides comparable and accurate information of a broad spectrum of firms in the UK, such as standardizing financials and ratios, which can facilitate the comparison among different industries and firms [30]

The Following Criteria are Applied for Data Selection in This Research

- Hotel industry is identified by the UK standard industrial classification of economic activities (UK SIC) with code 551, which stands for hotels and similar accommodations. In terms of food manufacturing, it is selected by UK SIC code 10 (manufacture of food products).
- The companies are selected according to the criteria of SME companies in FAME database. After selecting key variables, and removing observations with missing independent variables, the final unbalanced panel dataset consists of 1241 observations for food industry, and 1058 observations for hotel industry from the year 2014 to 2018.

Variables

A variety of variables have been applied in several studies of financial performance and capital structure use a variety of variables [17,18, 22, 24]. Prior research has employed accounting or by market-related indicators to measure financial performance, two kinds of indicators demonstrate different aspects of financial performance [31].

Accounting-based indicators include return on assets(ROA), return on equity (ROE), return on investment (ROI), net profit margin(NPM) [31-33], while market-related measures consist of earning per share (EPS), Market-to-book ratio, and Tobin's Q, Price to Earning (P/E) Ratio, Market Valuation [32, 34, 35]. However, data obtained from FAME database used in this research pertain to both listed and non-listed firms; no market-related financial indicators are shown for non-listed firms.

Hence, we only rely on accounting-based indicators for financial performance. Alshehhi, Nobanee [35] Investigated indicators used by extant studies in measuring financial performance and found that ROA was used in 53 out of the 132 papers, followed by ROE. According to Delcea, Bradea [36], financial performance could be evaluated reliably by ROA and ROE. Therefore, this research two the two most-used indicators to represent financial performance. In terms of capital structure, book value of GR is used as a measurement of capital structure in consistent with other studies [37-39]. This study aims to investigate the effect of GR on ROA and on ROE in SMEs in hotel and food manufacturing industries in UK. Firm characteristics are often used as control variables [40]. In line with previous studies, the following control variables related to firm characteristics are employed: size [41, 42], ages [43, 44], tangibility [45, 46], and asset turnover rate [47]. According to Kao, Yeh [48], firm size (SIZE) can be measured by a log of total assets. Hence, we take logarithmic forms to size to avoid potential normality issue.

Table 1: Description of variables

Variables	Names	Definitions
Gearing ratio	GR	(Short Term Loans & Overdrafts+ Long Term Liabilities)/Shareholders Funds (Source: FAME database)
Return on assets	ROA	Profit (loss) Before Tax /Total Assets (Source: FAME database)
Return on equity	ROE	Profit (loss) Before Tax /Total Equity (Source: FAME database
Firm size	SIZE	Represented by a log of total assets[48].
Ages	AGE	the observation year minus the year of incorporation [43].
Tangibility	TANG	Fixed assets/Total assets (Source: Compustat Global Vantage)
Total asset turnover	TAT	operating revenue divided by total assets [48].

Model Specification

To test the hypotheses, models used in prior studies [46, 49] was adapted to estimate capital structure and corporate financial performance. The Panel Least Square regression model is specified as follows: Model (1a & 1b):

$$ROE = \beta_0 + \beta_1 GR + \beta_2 SIZE + \beta_3 AGE + \beta_4 TANG + \beta_5 TAT + u$$

$$ROA = \beta_0 + \beta_1 GR + \beta_2 SIZE + \beta_3 AGE + \beta_4 TANG + \beta_5 TAT + u$$

In these models, the dependent variables are ROE, and ROA, while independent variable is gearing ratio (GR). In addition, we included firm-specific control variables such as size, ages, tangibility, and asset turnover rate. U is random noise.

Empirical Analysis

Diagnostic Tests

Prior to running regression, we employed student zed residuals to detect outliers. Observations with student zed residuals over 3.29 were removed before estimation [50].

Moreover, results of Breush-Pagan Lagrange test demonstrate the existence of heteroscedasticity problems in regressions. Newey-West procedure is therefore used to tackle this problem by showing heteroscedastic and autocorrelation-consistent (HAC) standard errors.

Descriptive Statistics

Table 2 presents the descriptive statistics for variables in food and hotel industries. 1241 observations are matched and merged for regression in food industry, while there are 1058 observations for hotel industry.

GR range from 0.03% to 893.4 % in food industry with the average at 77.85 %. ROE has a minimum of -492.21 % and a maximum of 190.26% with a mean at 18.08 %.

In terms of ROA, it ranges from -44.55 % to 64.22 % with the mean of 9.01 %. GR in hotel industry average at 112.48%, which is higher than that in food industry. Both ROE and ROA have lower mean value than food industry, 9.29% and 4.05% respectively. In terms of the variations, ROE and ROA in food industry vary more than those in hotel industry. GR in the hotel sector has higher variations.

Table 2: Descriptive statistic data

Variable	Mean	Max	Min	SD	N
Food Manufacturing					
GR	77.85	893.40	0.03	114.26	1241.00
SIZE	3.88	4.66	2.31	0.31	1241.00
AGES	30.56	109.00	2.00	21.27	1241.00
TANGIBILITY	31.79	94.29	0.04	18.58	1241.00
ASSET_TURNOVER	2.26	8.10	0.30	1.13	1241.00
ROE	18.08	190.26	-492.21	31.76	1241.00
ROA	9.01	64.22	-44.55	10.42	1241.00
Hotel Industry					
GR	112.48	998.58	0.00	130.01	1058.00
SIZE	3.91	5.07	1.53	0.44	1058.00
AGES	27.25	114.00	1.00	21.44	1058.00
TANGIBILITY	76.78	99.84	1.23	22.99	1058.00
ASSET_TURNOVER	0.63	6.76	0.03	0.59	1058.00
ROE	9.29	121.12	-92.84	17.55	1058.00
ROA	4.05	33.31	-30.72	6.58	1058.00

The data of controlling variables such as ages, tangibility, and asset turnover is also shown in Table 2. The mean of size is similar in two industries. Assets turnover in the food industry has higher mean and higher variations in assets turnover. Meanwhile, Hotel industry has higher value in tangibility on average and this variable varies more than that in the food industry

Correlation Analysis

As shown in Table 3 below, the results indicate that there is a weak correlation between GR and ROE (r =-0.120), between GR and ROA (r = -.290). Hence, a negative correlation between capital structure and financial performance is found in food manufacturing sector.

Table 3: Correlation analysis in food manufacturing industry

		Roe	Roa	Gr
Pearson correlation	ROE	1	.711**	-.120**
	ROA	.711**	1	-.290**
	GR	-.120**	-.290**	1
Sig.	ROE	-	.000	.000
	ROA	.000	-	.000
	GR	.000	.000	-
N	1243			

Note: ** Correlation is significant at the 0.01 level (2-tailed)

As shown in Table 4 below, no statistically significant correlation is found between GR and ROE in hotel sector. However, the results indicate that the correlation between GR and ROA is weak downhill at -.123.

Table 4: Correlation analysis in hotel industry

		Roe	**Roa**	**Gr**
Pearson correlation	ROE	1	.875**	.043
	ROA	.875**	1	-.123**
	GR	.043	-.123**	1
Sig.	ROE	-	.000	.158
	ROA	.000	-	.000
	GR	.158	.000	-
N	1068			

Note: ** Correlation is significant at the 0.01 level (2-tailed)

Regression Analysis

Hotel Industry

OLS regression is conducted that see whether capital structure has a significant impact on financial performance in hotel industry. Table 5 presents the panel least square regression results on ROE in hotel industry with heteroscedastic and autocorrelation-consistent (HAC) standard errors. It can be seen that GR, size, ages, tangibility and asset turnover are significant in explaining ROE. The model explains 22.7% of the total variance of ROE (R2= 0.227). Results indicate that GR has a significant effect on ROE (P=0.000, <0.001). However, the impact is positive rather than negative, which is contrary to what we have proposed in H1. The coefficient is 0.0304, suggesting that 1% rise of GR causes 0.0304 of increase in ROE. The model with ROE as the dependent variable in hotel industry can be written as follows: ROE=-6.3408 + 0.0304*GR + 4.9885*SIZE - 0.1301*AGES - 0.1309*TANGIBILITY + 10.0447*ASSET_TURNOVER

Table 5: OLS regression results in hotel industry (Dpt-ROE)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-6.3408	10.2277	-0.6200	0.5354
GR	0.0304***	0.0074	4.0915	0.0000

SIZE	4.9885**	2.2729	2.1947	0.0284
AGES	-0.1301***	0.0278	-4.6860	0.0000
TANGIBILITY	-0.1309***	0.0415	-3.1587	0.0016
ASSET_TURNOVER	10.0447***	1.8367	5.4689	0.0000
R2: 0.2267				
Adjusted R2: 0.2233				
DurbinWatson:1.1038				

Note: *, **, and *** represent 10%, 5% and 1% significance level

The results of regression on ROA are shown in Table 6 below. All variables including GR, size, ages, tangibility and asset turnover are significant in describing ROA. The model explains16.78% of the total variance of ROA (R2= 0.1678). Results indicate that GR is negatively associated with ROA (P=0.0193, <0.05). The coefficient is -0.004, suggesting that 1% rise of GR create a fall of 0.004% in ROA. Therefore, H2 is supported. The model with ROA as the dependent variable in hotel industry can be written as follows: ROA = -0.6948 - 0.0040*GR + 1.8854*SIZE - 0.0415*AGES - 0.0436*TANGIBILITY + 3.6697*ASSET_TURNOVER

Table 6: OLS regression results in hotel industry (Dpt-ROA)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.6948	4.2858	-0.1621	0.8713
GR	-0.0040**	0.0017	-2.3439	0.0193
SIZE	1.8854**	0.9236	2.0415	0.0415
AGES	-0.0415***	0.0113	-3.6705	0.0003
TANGIBILITY	-0.0436***	0.0147	-2.9722	0.0030
ASSET_TURNOVER	3.6697***	0.8173	4.4901	0.0000
R2: 0.1678				
Adjusted R2: 0.1639				
DurbinWatson:0.9290				

Note: *, **, and *** represent 10%, 5% and 1% significance level

Food Industry

Table 7 presents the panel least square regression results on ROE in food manufacturing sector with heteroscedastic and autocorrelation-consistent (HAC) standard errors. The model explains 4.8% of the total variance of ROE (R2= 0.048). Results indicate that GR has a significant effect on ROE at 10% level (P=0.0808, <0.10). The coefficient is -0.04, suggesting that for every 1% higher of GR, ROE decreases by 0.04%. Therefore, H3 is supported. Control variables including ages and asset turnover are significant at 1% level. The model regarding GR and ROE can be written as follows : ROE = 24.0427 - 0.0394*GR - 2.0026*SIZE - 0.1392*AGES + 0.0121*TANGIBILITY + 3.8775*ASSET_TURNOVER

Table 7: OLS regression results in food manufacturing industry (Dpt-ROE)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	24.0427	19.9910	1.2027	0.2293
GR	-0.0394*	0.0225	-1.7476	0.0808
SIZE	-2.0026	4.5428	-0.4408	0.6594
AGES	-0.1392***	0.0437	-3.1833	0.0015
TANGIBILITY	0.0121	0.0604	0.1999	0.8416
ASSET_TURNOVER	3.8775***	1.4961	2.5918	0.0097
R2: 0.0476				
Adjusted R2: 0.0437				
Durbin Watson:1.4002				

Note: *, **, and *** represent 10%, 5% and 1% significance level

Tables 8 also illustrate the results of OLS regression of GR on ROA in food manufacturing industry. The model explains10.5% of the total variance of ROA (R2 =0.105). Results manifest that GR has a significant impact on ROA (p =0.0000, <0.001). The coefficient is -0.0281, suggesting that every 1% higher of GR, ROA decreases by 0.0281%. Therefore, H4 is proved. Control variables except ages are not significant in describing ROA. The model concerning GR and ROA can be written as follows : ROA =21.2477 - 0.0281*GR - 2.2736*SIZE - 0.0478*AGES -0.0121*TANGIBILITY + 0.2777*ASSET_TURNOVER

Table 8: OLS regression results in food manufacturing industry (Dpt-ROA)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	21.2477	9.1312	2.3269	0.0201
GR	-0.0281***	0.0031	-8.9444	0.0000
SIZE	-2.2736	2.1062	-1.0795	0.2806
AGES	-0.0478**	0.0200	-2.3926	0.0169
TANGIBILITY	-0.0121	0.0240	-0.5049	0.6137
ASSET_TURNOVER	0.2777	0.5116	0.5429	0.5873
R2: 0.1051				
Adjusted R2: 0.1015				
Durbin Watson:0.9599				

Note: *, **, and *** represent 10%, 5% and 1% significance level

Conclusion

This study has set out to examine the influence of capital structure on financial performance of in SMEs in hotel and food manufacturing industries in UK over the period from 2014 to 2018. Data collected from FAME were utilized to explore the relationship. ROA and ROE are used as indicators of financial performance, while capital structure is measured by gearing ratio.

According to the result of OLS regression analysis, corporate financial performance represented by ROA and ROE in food manufacturing is influenced negatively by gearing ratio. In other words, a high level of debt does not lead to high level of financial performance, the result contradict the

conclusion drawn by Modigliani and Miller [10], which suggests that higher level of debt could contribute financial performance.

This inverse relationship could be explained by the Pecking Order theory proposed by Myers [51], illustrating that more profitable firms employ a lower level debt than less profitable ones. According to this theory, SMEs of food manufacturing tend to utilize internal resources in preference to external resources, which results in a low degree of debt.

This trend may indicate that SMEs are encountering the difficulties in accessing to external finance, which is one of the most important failure factors in SMEs [52]. Another possible explanation for this is the Trade-off theory, which states that investors would require a high-risk premium when a firm is aggressive in financing by debt because of the concern about the risk of financial distress. As can be seen from the Table 2, the average tangibility of food manufacturing is 31.79 %, which means SMEs in food manufacturing have a low proportion of tangible asset.

As a high-risk borrower with less tangible asset which can be used as collateral, lenders are likely to require high interest to compensate for the risk. In this sense, a higher cost of capital might exceed the increase in tax shield.

However, contradictory results are found in hotel industry. Gearing ratio has a negative effect on ROA, while a positive relationship can be found between gearing ratio and ROE. A possible explanation for this result may be the difference between ROA and ROE. ROA and ROE evaluate the financial performance from different aspects, ROA indicates the efficiency of utilizing assets, while ROE shows the profitability of employing shareholders' funds[53, 54].

Managerial Implications

The study concludes that capital structure has an inverse relationship with the financial performance of the SMEs in food manufacturing industry, while capital structure imposes mixed impacts on financial performance of SMEs in hotel industry. Financial managers should consider industry characteristics and employ an appropriate degree of financial leverage to maximize corporate value. Based on the findings of this study, it might not be recommended that SMEs in hotel industry should employ high level of debt or low level of debt to improve financial performance.

However, the model suggests that there is a negative relationship between tangibility and financial performance. To put it different, the SMEs in hotel industry with more tangible asset tend to have a poor financial performance. Since hotel industry features high capital intensive, it requires more capital to invest in tangible asset (e.g land and building).

Compared to other industry, firms with a higher proportion of tangible asset might cause higher earnings volatility. In this case, SMEs in hotel industry might implement asset-light and fee-oriented strategy, which could decrease the fixed cost by possessing less tangible asset and generate more fee income from management contracts and franchising [55].

However, the decrease in tangible asset might undermine the borrowing capability; financial managers of SMEs in hotel industry should strive a balance between Gearing ratio and tangibility in an effort to maximize profit.

In terms of food manufacturing industry, the model indicates that SMEs should avoid a high level of debt. From the perspective of policy makers, relevant policies should be conducted to increase the retaining profits for the SMEs. For example, a lower taxation or more tax allowances could be provided to SMEs. Furthermore, the models also demonstrate that SMEs may not fully use the tangible asset to affect financial performance.

Financial managers should increase the efficiency of utilizing tangible assets. Finally, under the pressure of raising funds from external, growth responsibility strategies could be conducted to handle it [56].

Limitations and Further Research

A variety of important limitations need to be considered. First, different accounting policies and period will impact the accuracy and comparability of data from the samples. Secondly, capital structure and financial performance can be evaluated in a more comprehensive manner by taking more variables into consideration.

Thirdly, ratios were calculated at a point in time from financial statement, which may not reflect capital structure and financial performance fairly. A possible direction in future research can be the investigation on how industry characteristics affect choice on capital structure.

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